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June 15, 2007

AGENDA ITEM 6

TO: MEMBERS OF THE PERFORMANCE AND COMPENSATION COMMITTEE

I. SUBJECT: Proposed Revisions to Investment Management Performance Award Plan Design

II. PROGRAM: Administration

III. RECOMMENDATION: Approve the Proposed Conceptual Revisions to the Investment Management Performance Award Plans

IV. ANALYSIS:

Background

The CalPERS Performance Award program and related policies have been developed over years of public review, discussion, and debate. The policies recognize that compensation systems must be carefully structured to both recognize labor market forces, and reinforce maximum performance through placing a substantial portion of total annual compensation at risk. The concept of performance awards is that a portion of an executive's annual total cash compensation is dependent upon making significant contributions to the achievement of key objectives of the organization.

Within the Investment Office, the performance award program applies to Investment Managers (Chief Investment Officer, Senior Investment Officers, Senior Portfolio Managers, and Portfolio Managers). The performance awards are based on individual performance plans, outlining position-specific measurable achievements relative to performance goals or targets. The individual plans are developed each year and presented to the Performance and Compensation Committee, which reviews and recommends action to the full CalPERS Board. The Board may modify the compensation policies and procedures and the compensation schedules derived from them at any time.

Over the years, the program has been continuously refined to ensure alignment of the interests of CalPERS investment program with the incentives provided. Last year, at its July 2006 offsite, the Board heard a panel presentation by industry experts on investment incentive compensation. Issues raised during this session included a discussion of the appropriate percentage of the incentive award to be linked to Total Fund (PERF) performance and the importance of measuring cost recovery.

In the incentive plans for 2006-07, the percentage award linked to Total Fund performance increased. For the Chief Investment Officer (CIO), it was increased from 20% to 35%; for the Senior Investment Officers (SIOs), with the exception of the SIO-Asset Allocation, it was increased from 10% to 25%; and for the Senior Portfolio Managers, it was increased from 0 to 10%. This change was intended to foster teamwork and collaboration across the asset classes.

Also in 2006-07, the qualitative factors were replaced with a leadership component. The leadership component is 25% for the CIO, and 15% for the SIO, SPM, and PM positions.

For the 2007-08 year, staff is recommending additional changes, which would refine and improve the benchmarks used in the incentive plans. In developing these recommendations, the CIO consulted with Senior Investment staff, as well as the Investment consultants and the Board's compensation consultant.

Proposed New Concepts

The objective of the performance benchmarks is to align the incentives of the Investment Office with the overall goals of the Investment Program. These benchmarks have generally reflected an index design standard commonly used to evaluate the success of many institutional investment managers. In addition to index benchmarks, however, it is also common practice among investment management institutions to ensure that incentive compensation standards fully reflect each of the key goals for the investment organization. This proposal seeks to define a new and more effective evaluative standard for the PERF overall as well as for the major asset classes.

Although the CalPERS Investment Office has historically employed index benchmarks in its incentive plans, we believe that additional alignment of interest with program objectives would be achieved by evaluating overall success based upon four key standards:

(1) Performing well against an index/design benchmark,
(2) Performing well compared to peers,
(3) Performing well against an absolute or actuarial standard, and
(4) Investing efficiently.

Thus, for those years (and particularly for longer evaluation periods) in which the PERF outperforms its design benchmark, outperforms other public pension plans in the United States, makes actuarial progress (by increasing its funded ratio), and achieves investment efficiency (i.e., a high information ratio), the fund can be said to be fully on track in its core investment objectives.

In addition, we have reviewed the current incentive compensation standards to ensure that they fully reflect the excellence which we are expecting and targeting in our Investment Program. Currently, incentive compensation is defined by three reference levels equal to zero or minimum bonus (score=0), target (i.e., 2/3 of maximum) bonus (score=1.0), and maximum bonus (score=1.5). For the PERF overall and for each of the major investment units including Global Equities, Fixed Income, Alternative Investments (AIM), and Real Estate, the current incentive compensation schedule relative to index benchmarks is as follows:

	Min	Target	Max
PERF	-40 bps	0 bps	+20 bps
Global Equities	-50 bps	-10 bps	+15 bps
Fixed-Income	0 bps	+40 bps	+60 bps
AIM	0 bps	+150 bps	+250 bps
Real Estate	0 bps	+50 bps	+75 bps

Details of Proposed Incentive Compensation Standard

The key concept in expanding the criteria in which to evaluate success is to align the incentive compensation with key objectives of the Investment Office. For the PERF overall over one-, three- and five-year horizons, these objectives can be expressed in the following four evaluative standards:

	Min	Mid	Max
Performance versus Index Benchmark (weight=1/2)	-.5%	0	+.5%
Performance versus Public Pension Fund Peers (1/6)	Bottom Quartile	Median	Top Quartile
Performance versus Actuarial Target (1/6)	CPI+3%	CPI+5%	CPI+7%
Investment Efficiency: Information Ratio (1/6)	-0.5	0	+0.5

Effectively, these standards set a midpoint for incentive compensation at a neutral point for performance versus index benchmarks, but also at levels of performance comparable to that of other large public pension plans in the United States, and at an absolute level which meets our long-term actuarial goals. The information ratio (i.e., excess return relative to the index/ tracking error volatility relative to the index) would also be neutral at the incentive compensation midpoint. However, for staff to receive maximum incentive compensation the PERF would need to outperform its index benchmark by 50 bps, would need to be a top quartile performer among public pension funds, would need to achieve an absolute return of CPI+7%, and would need to earn an information ratio of +0.5 (a level which has commonly been accepted as indicating strong performance). Incentive compensation would be calculated as a simple linear interpolation between the minimum bonus threshold (0%) and the maximum bonus threshold (100%). To be certain, performance of the PERF at the maximum bonus levels would demonstrate investment prowess relative to its fund design, expertise compared to other pension funds, improvement of actuarial funding status, and investment efficiency in achieving its return targets.

We would also recommend a continuation of using one-, three-, and five-year performance horizons to evaluate the effectiveness of CalPERS portfolio management staff. Of course, investment managers with shorter than a five-year history with CalPERS would have shorter effective periods for evaluation. The schedule which outlines the importance of each time horizon can be defined by the following table:

# years of PM History	% ascribable to each time horizon				
	1-yr	2-yr	3-yr	4-yr	5-yr
1	100%	0%	0%	0%	0%
2	40%	60%	0%	0%	0%
3	30%	0%	70%	0%	0%
4	20%	0%	40%	40%	0%
5	10%	0%	40%	0%	50%

The investment objectives for each of the major asset classes as well as for each component of these classes would then be defined so as to achieve the overall objective of the PERF. Specifically, we recommend the following evaluative standards for Global Equities, Fixed-Income, Private Equity, and Real Estate:

	Min	Mid	Max
Global Equities			
Performance versus Index	-.25 %	0	+.25%
(note: relatively narrow spread reflects impact of large index programs)			
Fixed Income			
Performance versus Index	-.30%	0	+.30%
(note: securities lending benefit would no longer accrue solely to FI)			
Private Equity			
Performance versus Venture Economics Peers (3/4)	Median-5%	Median	Median+5%
Performance versus Equity Market Benchmark (1/4)	W2500	W2500+2%	W2500+4%
Real Estate			
Performance versus 90% NCREIF+ 10% NAREIT Index (3/4)[1]	-.05%	+.9%	+1.85%
Performance versus TUCS Peer Group (1/4)	Bottom Quartile	Median	Top Quartile

Although the proposed incentive compensation is generally more aggressive than ones employed in past years, it also would be more closely aligned with the overall objectives of the PERF. For each of the asset classes, we will also begin to measure efficiency ratios (i.e., appropriate information and Sharpe ratios) so that we may include them for consideration in the future. Efficiency ratio measures help to reward risk-adjusted performance but we believe that some time will be required for portfolio managers to become comfortable with the measures before they should be implemented. Overall, the incentive compensation schedule for each of the major asset classes and each component of these asset classes should correlate strongly with overall success for the PERF.

We would also recommend that the new schedule be implemented on a going-forward basis but that the benchmarks used historically for each portfolio manager and investment program be applied to historical performance. Thus, a transition methodology will be established with Wilshire and portfolio management staff in order to ensure an appropriate and fair transition schedule. Currently, we propose that the phase in occur 20% each year so that the new schedules are fully implemented after 5-years.

[1] Composites for the real estate benchmark are calculated based on a (min,mid,max) range relative to NCREIF of (0%,1%,2%) and relative to FTSE EPRA NAREIT Global Real Estate Index of (-.5%,0%,+.5%).

Integration with Asset/Liability Workshop Recommendations

The objective of the Asset/Liability Management Workshop is to allow the Board to set allocation targets and ranges for a three year horizon. In effect, portfolio management staff, the SIOs, and the CIO apply these allocation targets and ranges to each applicable investment program and give each portfolio manager specific benchmark targets, the range of permissible investments, and risk limits (if applicable). Accordingly, the Board should be able to evaluate the expected role of each investment program in terms of its ability to meet the objectives of the PERF. Thus, establishing appropriate incentive compensation benchmarks is essential for proper evaluation of the role and effectiveness of each investment program.

Consultant Review

The Board's Investment consultants, Wilshire Associates and Pension Consulting Alliance (PCA), have reviewed this proposal and concur with the concept. In addition, the Board's compensation consultant, Watson Wyatt Worldwide has reviewed the proposal. Wilshire's opinion letter is provided as Attachment 1, PCA's opinion letter is provided as Attachment 2, and Watson Wyatt Worldwide's opinion letter is provided as Attachment 3.

Next Steps

If the principles defined in this proposal are accepted by the Performance and Compensation Committee, investment staff will then submit a detailed schedule of incentive compensation standards for CalPERS Investment Managers at the next Committee meeting in August 2007. Details to be developed in the interim include: definition of the public pension fund peer group; standards and weightings for the proposed inflation-linked asset class; standards and weightings for each SIO, SPM, and PM as appropriate given the overall objective for the PERF and each major asset class; and precise definition of the historical standards compared with new standards for all Incentive Compensation schedules. The policies and procedures would also be modified to reflect the changes. In accordance with usual practice, the August item will be presented as a First Reading; the Committee will have the option to accept it or to request changes for a Second Reading in September.

V. STRATEGIC PLAN:

This item is consistent with the Strategic Plan:

- Goal 2, foster a work environment that values quality, respect, diversity, integrity, openness, communication, and accountability.

- Goal 3, sustain a high performance work culture utilizing staff development, technology, and innovative leadership and management strategies.
- Goal 8, manage the risk and volatility of assets and liabilities to ensure sufficient funds are available, first, to pay benefits, and second, to minimize and stabilize contributions.

VI. RESULTS/COSTS:

No direct cost would be incurred with changing the incentive compensation benchmarks for the Investment Office. In addition, aligning these benchmarks better with the overall objectives of the Investment Office should improve long-term investment performance, contribute to progress against actuarial goals, and promote efficient investment for appropriate risks undertaken by investment staff.

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